



FAR

Financial Accounting and Reporting

CPA Exam Review

2026
Edition

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- GASB Codification of Governmental Accounting and Financial Reporting Standards and GASB Statements
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Keeping the course materials updated and accurate would not be possible without the contribution of our team of content experts. Our team includes academics and professionals who have expertise and experience in their respective fields; several have had experience at the Big Four or have PhDs in areas related to the exam. All are passionate about helping candidates pass the exam and about UWorld's dedication to creating the highest-quality materials.

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Introduction

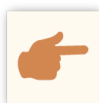
How to Best Use Your Course

Welcome to the UWorld CPA Review course! Our expert team is passionate about helping you succeed and has developed an award-winning program that is proven to yield results. Before you get started, please read through this guide on how to best use your course so that you can master all of the topics laid out for you in the AICPA Blueprints and ultimately pass the CPA Exam. At UWorld, our passion is to make the hard stuff easy to learn and understand.

Plan Your Studies

When preparing for the CPA Exam, half the battle is setting yourself up for success with a solid plan from the get go. This includes establishing short- and long-term goals to ensure you're staying on track.

To get started, use the Study Plan in your course. Start your plan by setting the beginning and ending dates for your schedule. Then select your pace (Fast Track versus Customize) and set the number of hours per day you will study. The system will create your plan based on your choices. It is important to follow your plan steadily so that you can ensure you hit your goals. If you miss a day, make it up!



Tip!

Download the app; this gives you access to everything your course offers even while on the go.

Master the Concepts through Active Learning

With this program, you will build your foundational knowledge and mastery of core exam topics through **active learning**. This evidence-based learning methodology centers around the principle that students retain information best when they actively participate in answering questions.

- **Begin with the Representative Task.** Read through each representative task carefully. (The Representative Tasks are from the AICPA Blueprints and are presented in our books and videos to guide you through the materials.) Pay particular attention to the words at the beginning of the task; they provide guidance on level and focus
- **Scan the book chapter.** Do you feel confident with the material? If you do, you might want to move directly to the questions and begin to practice. If you find that you are hesitant about an area, read the book or watch the video to solidify your understanding before you practice on some questions
- **Watch the videos.** If you prefer to absorb material on video rather than by reading the book, you will notice that the videos are deliberately set up in small segments. Our team created these segments so you can review what you need, either as part of the whole topic or for specific review of a smaller area
- **Practice the questions.** In our question bank (our QBank) we have taken great care to provide you with very high-quality questions and explanations. Each explanation not only tells you why the concept tested is important to understand but also teaches you why the answer is correct and why the other answer choices are not correct. Images, tables, definitions, and TBS Mastery videos also help fill in gaps as you use the questions and explanations to learn by doing

Track Your Progress and Performance

As you complete each chapter, track your progress and performance using our signature **SmartPath Predictive Technology™**. SmartPath is a data-driven platform that provides recommended targets based on those of previous students who have passed the CPA Exam. This is an important tool to help you study efficiently and gauge whether you are *exam-ready*. Your goal is to hit both your progress target (Questions Attempted) and performance target (Score) for each chapter.

As you work through the material, don't worry about hitting your "Score" target right away and focus your efforts on hitting the "Questions Attempted" target first. This approach may feel uncomfortable, but trust that you are building your knowledge as you absorb the answer explanations.

Once you've completed all the topics in a chapter, you can go back and focus your efforts on hitting the "Score" target. If you are falling short, drill down in the Performance tab to see which topics need extra attention.



Tip!

Don't over-study. **SmartPath™** helps determine when you can move on to the next topic.

Solidify the Concepts

Need extra help mastering the concept? Take advantage of the additional learning tools that are integrated into your course. For example, you could be working through a difficult question and find you need further explanation. No problem! There's a link to the supporting lecture right there in the question. Want to remember something for later review? You can easily transfer content directly from the question to a digital flashcard. These are just a few ways we make it easy for you to navigate to and access the right tools at the right time.

These additional tools are designed to enhance your studies—**you do not necessarily need to read or watch all of this material!** Rather, use these tools as a means to improve on any weak areas you might have:

- **Video Lectures** – From the Lectures tab or from the direct link at the bottom of each practice question, you have access to the profession's most motivating and effective lecturers. The lectures break down difficult topics into simplified concepts and provide helpful memory aids. These are especially recommended for visual and auditory learners
- **Textbooks** – The video lectures are accessible side by side with the digital eTextbooks or, in some of our course packages, a printed format. These guides can be used as a reference if you need further explanation of a concept. Many students also find it beneficial to follow along in the textbook while watching the lectures and taking notes, either directly in the physical books or by using the Notes feature and highlighting tool in the platform
- **Digital Flashcards** – Create custom flashcards directly from your practice questions by clicking on the lightning bolt symbol. Depending on your program package, your course may also be pre-loaded with an "Expert Deck" of flashcards covering the most heavily tested topics. You can review all your cards in Study Mode or by using our **spaced-repetition technology**. This is an evidence-based learning method that presents cards you've marked as *difficult* more frequently and cards you've marked as *easy* less frequently. The spacing of how and when the flashcards are introduced has been proven to increase retention and strengthen memory recall

Get Exam-Ready

The final days leading up to the exam are a critical time in which you're going to want to review your SmartPath data and ask, "Am I *exam-ready*?" If you have hit all the targets, you are in a really good spot. However, if any areas are still marked "Needs Improvement," now is the time to focus your efforts on meeting those targets.

We recommend you **take at least one full practice exam before exam day** (click on the "Exam Sim" tab in the QBank). This allows you to hone your test-taking skills in an exam-like environment that follows the same 5-testlet, 4-hour structure as the exam. The Exam Sim pulls questions from the QBank, and there is no limit to the number of times you can create an Exam Sim.

As a final step to assess your exam day readiness, we recommend you take the full-length mock exam. Curated with a unique set of questions not featured in the regular QBank, these practice tests are directly aligned to the content allocation and difficulty level of each CPA exam testlet. We recommend using this feature about 1–2 weeks before exam day.

AICPA Blueprints

The UWorld CPA Review course is based on the AICPA Blueprints, which show candidates what skills and content topics will be tested on the CPA Exam. You don't have to make tough decisions about what concepts to focus on. If you follow our methodology, you will be well on your way to passing the exam.

Let's take a look at what we mean by starting with the AICPA Blueprints. The Blueprints have four levels:

- Area
- Group
- Topic
- Representative Task

Each Representative Task also has a Skill level.

- Remembering & Understanding
- Application
- Analysis
- Evaluation (used only in AUD)

The Table of Contents of the book shows how each UWorld textbook is set up to follow the order of the AICPA Blueprints, with

- Area
- Group
- Topic

In the pages of each book, we provide the Representative Tasks from the AICPA Blueprints. We did that to make a direct connection between the exam and our content. Our team deliberately focused on what the Tasks say and wrote study materials that match with each Task. There is no closer connection between what will be tested and what you are studying.

Beyond connecting to the topics of the AICPA Blueprints, our team also differentiated the textbook content to match the Skill Levels of the Tasks.

- **Remembering & Understanding** tasks require you to understand the definitions and fundamentals of the topic. We have presented the information in these areas with an eye to creating clear explanations of the topics
- **Application** tasks are more about using your knowledge in scenarios to indicate that you understand the concepts. Our authors have therefore provided examples that show you how to apply your knowledge in specific situations. Many of these examples are similar to questions that you will find on the exam
- **Analysis** tasks require a higher level of thinking, many times requiring you to choose one outcome over another or to make a decision. On the exam, these tasks will always be addressed in Task-Based Simulations, or TBSs. The AICPA intentionally makes these more challenging to determine if you really know the material and can work with it as a professional. In our materials, our authors often guide you through the critical thinking required to work with TBSs
- **Evaluation** tasks are only in the AUD section of the exam and are at the highest level of thinking. They go a step further than the Analysis level and require you to evaluate or judge different approaches or outcomes

The CPA Exam

Within the AICPA Blueprints, there is information about how much time candidates have for each section and how many questions each section contains, categorized by question type. Question types include Multiple-Choice Questions (MCQs) and Task-Based Simulations (TBSs).

Section	Section Time	Multiple-Choice Questions (MCQs)	Task-Based Simulations (TBSs)
AUD – Core	4 hours	78	7
FAR – Core	4 hours	50	7
REG – Core	4 hours	72	8
BAR – Discipline	4 hours	50	7
ISC – Discipline	4 hours	82	6
TCP – Discipline	4 hours	68	7

Scoring Weight by Exam Section

The AICPA also shows candidates how the question types for each section are weighted and account for their overall score.

Section	Score Weighting	
	Multiple-Choice Questions (MCQs)	Task-Based Simulations (TBSs)
AUD – Core	50%	50%
FAR – Core	50%	50%
REG – Core	50%	50%
BAR – Discipline	50%	50%
ISC – Discipline	60%	40%
TCP – Discipline	50%	50%

Skill Allocations

As mentioned earlier, each Representative Task is tested at a specific Skill Level, and each part of the exam has its own weighting of the Skill Levels, as seen here.

Section	Remembering & Understanding	Application	Analysis	Evaluation
AUD – Core	30–40%	30–40%	15–25%	5–15%
FAR – Core	5–15%	45–55%	35–45%	–
REG – Core	25–35%	35–45%	25–35%	–
BAR – Discipline	10–20%	45–55%	30–40%	–
ISC – Discipline	55–65%	20–30%	10–20%	–
TCP – Discipline	5–15%	55–65%	25–35%	–

Content Allocations

The AICPA Blueprints address how coverage of the various content areas is allocated in each exam. Using the UWorld system that ties directly to the Blueprint structure, it is easy to see the extent to which each topic is covered.

AUD

Content Area		Allocation
Area I	Ethics, Professional Responsibilities, and General Principles	15–25%
Area II	Assessing Risk and Developing a Planned Response	25–35%
Area III	Performing Further Procedures and Obtaining Evidence	30–40%
Area IV	Forming Conclusions and Reporting	10–20%

FAR

Content Area		Allocation
Area I	Financial Reporting	30–40%
Area II	Select Balance Sheet Accounts	30–40%
Area III	Select Transactions	25–35%

REG

Content Area		Allocation
Area I	Ethics, Professional Responsibilities, and Federal Tax Procedures	10–20%
Area II	Business Law	15–25%
Area III	Federal Taxation of Property Transactions	5–15%
Area IV	Federal Taxation of Individuals	22–32%
Area V	Federal Taxation of Entities (including tax preparation)	23–33%

BAR

Content Area		Allocation
Area I	Business Analysis	40–50%
Area II	Technical Accounting and Reporting	35–45%
Area III	State and Local Governments	10–20%

ISC

Content Area		Allocation
Area I	Information Systems and Data Management	35–45%
Area II	Security, Confidentiality, and Privacy	35–45%
Area III	Considerations for System and Organization Controls (SOC) Engagements	15–25%

TCP

Content Area		Allocation
Area I	Tax Compliance and Planning for Individuals and Personal Financial Planning	30–40%
Area II	Entity Tax Compliance	30–40%
Area III	Entity Tax Planning	10–20%
Area IV	Property Transactions (disposition of assets)	10–20%

Exam Testlets

Each section of the exam is divided into five testlets. Two testlets cover MCQs and three testlets cover TBSs. Not all sections have an equal number of MCQs and TBSs, as the following chart shows.

Section	Testlet					Total	
	1 MCQ	2 MCQ	3 TBS	4 TBS	5 TBS	MCQ	TBS
AUD – Core	39	39	2	3	2	78	7
FAR – Core	25	25	2	3	2	50	7
REG – Core	36	36	2	3	3	72	8
BAR – Discipline	25	25	2	3	2	50	7
ISC – Discipline	41	41	1	3	2	82	6
TCP – Discipline	34	34	2	3	2	68	7

Finally, to manage your time effectively in the exam, we recommend that you:

- Use 75 seconds per multiple-choice question as a benchmark,
- Allocate 15–20 minutes per task-based simulation, depending on complexity, and
- Take the standard 15-minute break after the third testlet; it doesn't count against your time.

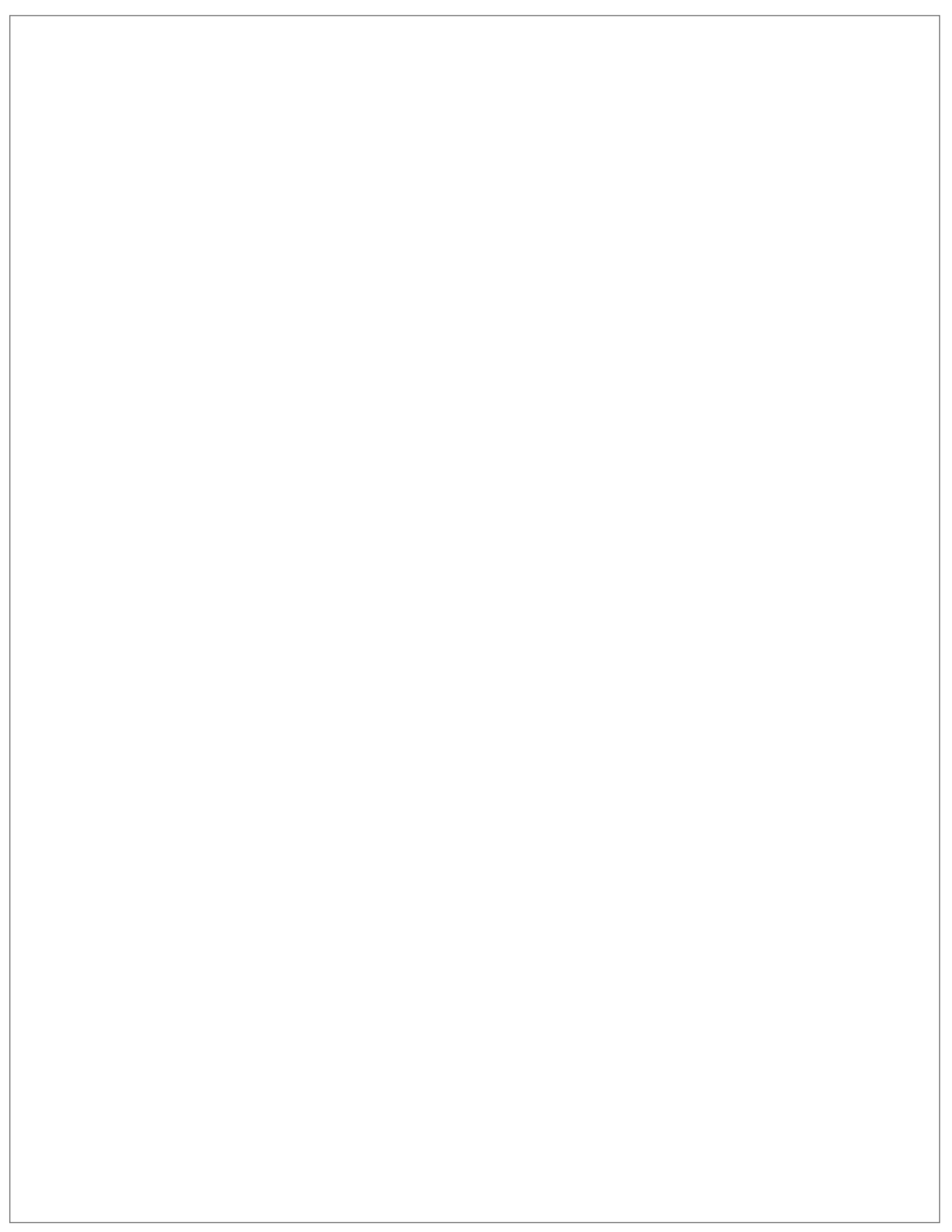
To see the full AICPA Blueprints, visit the AICPA website.

Above all, start the study process with confidence! As Roger always says, "You do not have to be a genius to pass the CPA Exam. If you study, you will pass!" You've got this.



FAR

Area I: Financial Reporting





FAR 1
**General-Purpose Financial
Reporting: For-Profit
Business Entities**

FAR 1: General-Purpose Financial Reporting: For-Profit Business Entities

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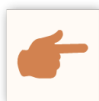
1.01 Balance Sheet/Statement of Financial Position

Reporting Under GAAP

Publicly held companies are required to submit their financial statements (F/S) to the SEC prepared in accordance with a general purpose framework, either:

- Generally Accepted Accounting Principles (GAAP), or
- International Financial Reporting Standards (IFRS).

Nonpublic entities may choose to follow a general purpose framework or a special purpose framework. The FAR exam tests CPA candidates' knowledge of how transactions, events, and circumstances are accounted for and how they are reported on. Most FAR questions are based on GAAP.



For additional coverage on special purpose frameworks, see the FAR Special Purpose Frameworks chapter.

GAAP is developed by the Financial Accounting Standards Board (FASB), which is authorized to establish accounting standards by the Securities and Exchange Commission (SEC). The FASB Accounting Standards Codification (ASC) is the single source of authoritative GAAP for nongovernmental entities.

GAAP employs the **accrual basis** of accounting. Under accrual accounting, revenues are recognized in the period earned (regardless of when they are collected), and expenses are recognized in the period incurred (regardless of when they are paid). A recognized item is depicted in both words and numbers, with the amount included in F/S totals. An item must meet three criteria to be recognized in the F/S. The criteria are:

- **Definitions:** The item meets the definition of an element of F/S
- **Measurability:** The item is measurable and has a relevant measurement attribute
- **Faithful representation:** The item can be depicted and measured with faithful representation

Derecognition removes an item from the F/S when it no longer meets any one of the recognition criteria. Expenses may be recognized based on the following:

- **Cause and effect:** Expenses that produce revenue at identifiable points in time can be directly matched to revenues (eg, cost of goods sold)
- **Systematic and rational allocation:** Expenses that produce revenue over long periods of time are matched to those periods using a reasonable means of allocation (eg, depreciation)
- **Immediate recognition:** Some expenses cannot be directly related to specific benefits so they are expensed as incurred (eg, monthly salaries of selling, general and administrative employees)

For further discussion of revenue recognition, see the FAR Revenue Recognition chapter.

Overview



Representative Task (Application): Prepare a classified balance sheet from a trial balance and supporting documentation.

The balance sheet, also called the statement of financial position, reports the resources of a company at a point in time. It is dated as of a specific date (eg, December 31, Year 1). On the balance sheet, a company discloses its economic resources (ie, assets) and the manner of financing the acquisition of those resources (ie, liabilities to creditors and equity from owners' contributions/prior year's earning).

Three Basic Elements of Financial Statements

Assets	=	Liabilities	+	Equity
<ul style="list-style-type: none"> • Economic resources • Include probable future benefits • Controlled by an entity • Derived from past events 		<ul style="list-style-type: none"> • Unavoidable obligations • Settled with assets • Derived from past events 		<ul style="list-style-type: none"> • Calculated as assets minus liabilities • Represents ownership interest

Assets are presented in order of decreasing liquidity (ie, ease of conversion to cash). The most liquid assets are shown first (eg, cash), and less liquid assets are shown last (eg, property, plant, and equipment). Liabilities are presented in order of maturity. Current liabilities are presented first, then long-term liabilities are presented. Owners' equity (also called shareholders' equity) items are shown in order of permanence.

A classified balance sheet separately presents assets and liabilities as *current* or *noncurrent*:

- **Current assets** will be consumed or converted into cash within one year or the operating cycle, whichever is longer. Examples include cash, temporary trading securities, accounts receivable, notes receivable, inventories, and prepaid expenses
- **Current liabilities** will be settled within one year or the operating cycle, whichever is longer. Examples include accounts payable, accrued expenses, dividends payable, income taxes payable, and the current portion of long-term debt
- **Noncurrent assets and liabilities** are defined by exclusion. All assets and liabilities that do not meet the criteria necessary to be classified as current (ie, items that are generally longer than one year) are classified as noncurrent

The valuations of major balance sheet accounts are summarized below and will be further explained in the chapter that pertains to each account:

Account Type	Measurement Basis
Receivables	Net realizable value
Inventory	Lower of cost or market, or lower of cost or net realizable value

Account Type	Measurement Basis
Investments in marketable securities	Market value
Property, plant, and equipment and intangibles	Historical cost and depreciated/ amortized historical cost
Liabilities	Present value
Equity	Historical value of cash inflows and residual valuation

The balance sheet provides information useful in assessing the entity's financial strengths and weaknesses, especially risk (eg, relative proportion of debt to equity), and the allocation of assets.

The following is an example of a GAAP balance sheet:

Company Name Balance Sheet/Statement of Financial Position <i>As of December 31, Year XX</i>	
Assets	Liabilities and Shareholders' Equity
Current assets: Cash and cash equivalents Temporary term investments (eg, trading securities) Receivables, net of allowance Inventories Prepaid expenses (eg, insurance, rent) <i>Total current assets</i>	Current liabilities: Short-term notes payable Accounts payable (eg, to vendors, accrued salaries and wages) Estimated current liabilities (eg, warranty expense) Unearned revenue Current portion of long-term debt <i>Total current liabilities</i>
Investments: Nonmarketable securities (eg, equity method securities) Long-term investments in marketable debt securities (eg, AFS or HTM)	Noncurrent liabilities: Notes payable (net of current portion) Bonds payable Deferred tax liability <i>Total noncurrent liabilities</i>
Property, plant, and equipment: Land, buildings, and improvements Machinery and equipment	Total liabilities
Intangibles: Goodwill Other identifiable intangibles (eg, trademarks, patents) <i>Total noncurrent assets</i>	Shareholders' equity: Preferred stock Common stock Additional paid-in capital Retained earnings Accumulated other comprehensive income <i>Total shareholders' equity</i>
Total assets	Total liabilities and shareholders' equity

1.02 Income Statement/Statement of Profit or Loss

Overview



Representative Task (Application): Prepare a single-step or multi-step income statement (eg, operating, nonoperating, discontinued operations) from a trial balance and supporting documentation.

The income statement, also called the statement of profit or loss, measures performance of a firm for a period of time (eg, monthly, quarterly, annually). The income statement is prepared using the all-inclusive approach. That is, most revenues, expenses, gains, and losses are shown on the income statement and are included in the calculation of net income.

There are other items that would appear to be income items but are classified as other comprehensive income (OCI), which are excluded from net income. Remember these OCI items with the mnemonic **DENT**: **D**erivative cash flow hedges, **E**xcess adjustment on defined benefit pension plans, **N**et unrealized gains and losses on available-for-sale debt securities, and **T**ranslation adjustments from foreign currency. Similarly, prior-period adjustments are reflected in retained earnings rather than in net income.

An income statement generally contains two sections: **income from continuing operations** and **discontinued operations**. Income from continuing operations may be prepared using either the multi-step approach or single-step approach.

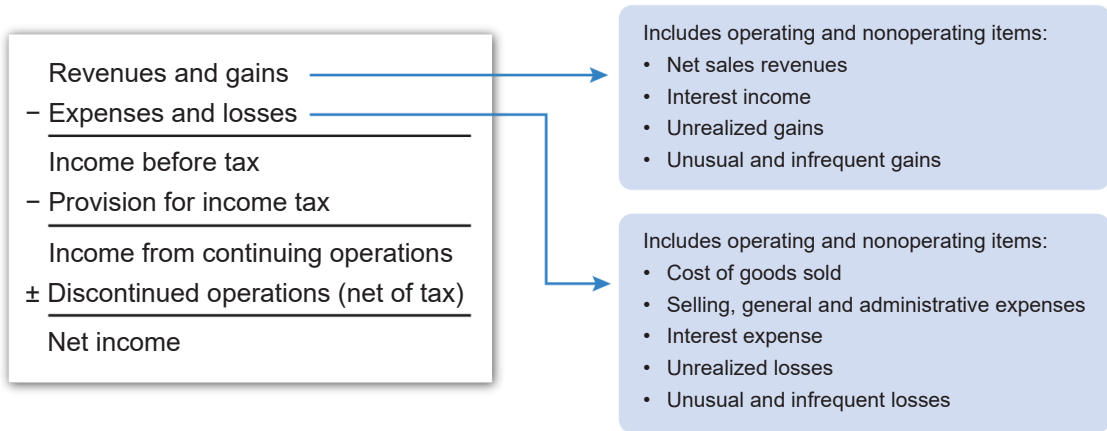


Revenues and expenses relate to the company's primary business operations, while gains and losses relate to peripheral or incidental transactions. The multi-step approach separates items related to the company's primary business (ie, operating items) from peripheral or incidental items (ie, nonoperating items). The single-step approach does not.

Single-Step Approach

The single-step format involves a presentation of income from continuing operations that is largely based on a single comparison of total revenues and gains to total expenses and losses. Here, revenues/gains and expenses/losses are grouped together.

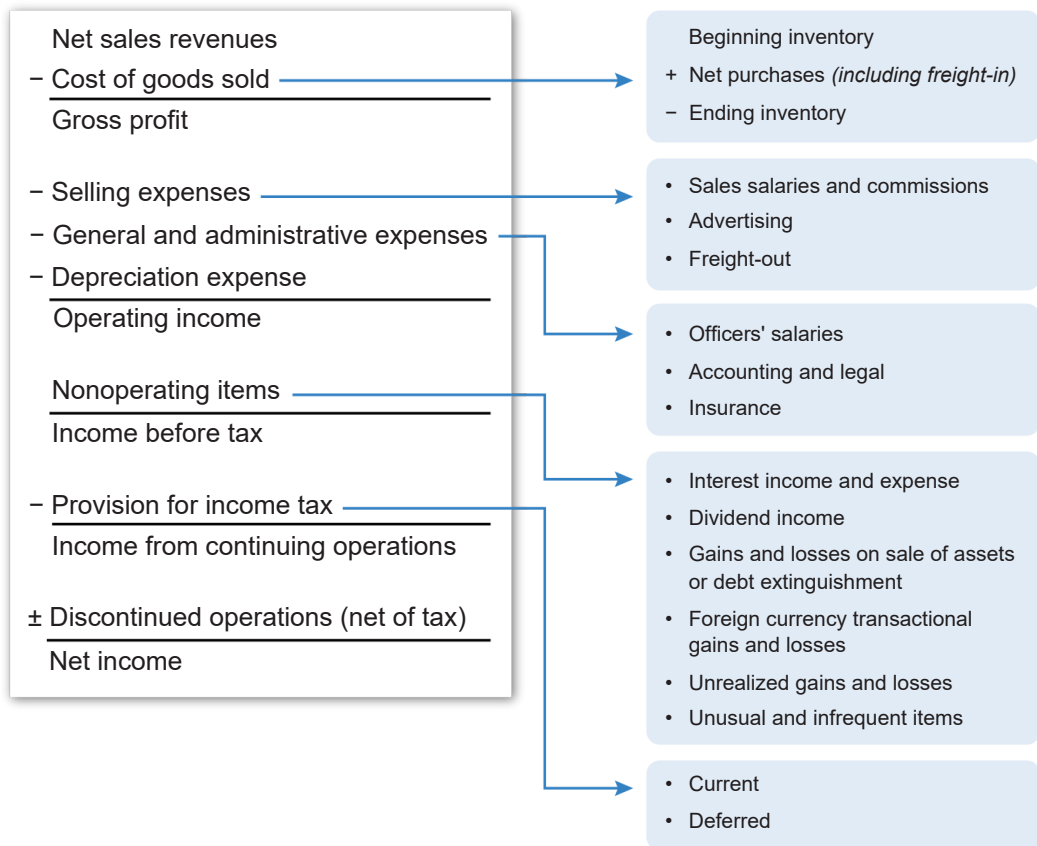
Single-Step Income Statement



Multi-Step Approach

The multi-step format involves a presentation of income from continuing operations that includes multiple comparisons of revenues, expenses, gains, and losses. The statement begins with revenues, then subtracts operating expenses to arrive at operating income (ie, income directly tied to the company's primary business operations). Following operating income, nonoperating items (eg, interest expense or peripheral gains) and income tax expense are listed to arrive at income from continuing operations.

Multi-Step Income Statement



Note: Credit loss expense could be either selling expense or general and administrative expense.

Discontinued Operations

When an entity decides to dispose of a portion of its business, it may be accounted for as discontinued operations or a disposal of assets. A disposal is reported as discontinued operations when the disposal represents a **strategic shift** that will have a significant effect on the entity's operations and financial results. Otherwise, the disposal is reported simply as a disposal of assets.

Strategic Shift

A strategic shift includes the following:

- Disposal/discontinuation of operations in a major geographic area
- Disposal/discontinuation of a major line of business
- Disposal of a significant investment accounted for under the equity method
- Disposal/discontinuation of other major "parts" of an entity

Held for Sale

A component or group of components that qualifies as a strategic shift will be reported in discontinued operations if it is disposed of by sale or by some other means during the period or if it qualifies to be classified as "held for sale." A component qualifies as held for sale if all the following criteria are met:

- A plan to sell the component has been committed to by those who have the authority to do so
- The component is in salable condition and available for immediate sale
- Action to complete the plan for disposal has been initiated, and a buyer is being actively sought
- The sale is probable and expected to be completed and to qualify for recognition within one year
- The price at which the component is being marketed is reasonable
- It is unlikely that significant changes will be made to the plan or that it will be withdrawn

Financial Statement Presentation

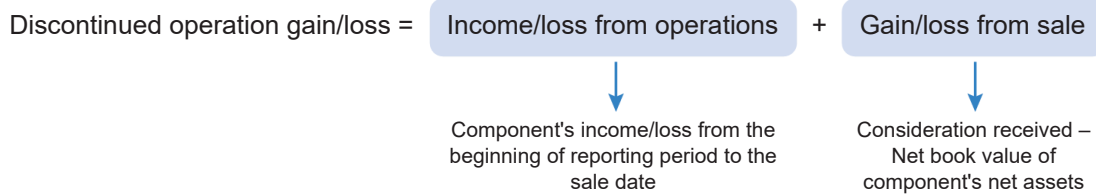
All assets and liabilities of the discontinued operation are presented separately on the balance sheet for all periods presented.

Discontinued operations are presented separately on the income statement to alert financial statement users that this portion of the business will not be a part of ongoing operations. The income of a discontinued operation and any gain or loss from its disposal are separated from continuing operations for all periods presented, even though in previous periods the income from the segment was part of continuing operations. On the income statement, discontinued operations are listed below income from continuing operations (which includes the provision for income taxes), so discontinued operations are presented **net of tax**.

Calculation of Income Statement Discontinued Operations

The discontinued operations portion of the income statement includes the income (or loss) from operations of the component, and either an impairment loss expected to occur from a future sale (if any, but gains are not recognized), or the gain (or loss) from the actual sale.

Sale of Discontinued Operation Financial Reporting



The following rules apply in the calculation of the discontinued operations for income statement purposes:

Recognizing Elements of a Discontinued Operation		
Element	Accounting Treatment	Calculation
Operating income/loss	Recognized (net of tax) in period incurred	
Gain on sale (actual)	Recognized (net of tax) in year of disposal	Sales price – book value
Loss on sale (actual)	Recognized (net of tax) in year of disposal	Sales price – book value
Impairment loss (anticipated)	Recognized (net of tax) immediately upon "held for sale" classification <ul style="list-style-type: none"> Occurs when an asset's book value exceeds its net realizable value (NRV, ie, fair value less cost of disposal) If the book value is less than NRV, no gain is recognized (the asset can only be written down, not up) 	NRV – book value

On the income statement, each component of the gain or loss from discontinued operations can be presented separately (as shown in the example below), or a net figure can be presented with footnote disclosures detailing the separate components.

Example Presentation of Discontinued Operations on the Income Statement		
Income from continuing operations		\$10,000
Discontinued operations		
Loss from operations (net of tax benefit)	(\$1,500)	
Gain on disposal (net of tax expense)	1,000	
Loss on discontinued operations		(500)
Net income		\$9,500



On June 1, Year 5, management of Hudson Co. committed to a plan to dispose of Howard Co., a major subsidiary. The sale meets the requirements for classification as discontinued operations and is anticipated to occur during Year 6.

Howard earns an operating income of \$500,000 in Year 5, and management anticipates that Howard will incur an operating loss of \$1,600,000 in Year 6. In Year 5, management determines that the book value of the business unit is \$10,000,000 and the fair value less cost of disposal is \$8,000,000.

Assume that the tax rate is 30%. Determine what Hudson should report for discontinued operations in its Year 5 income statement.

Operating income/loss is included as part of discontinued operations in the period it is incurred, not anticipated. Impairment losses are recognized immediately, even if the disposal has not occurred yet.

Hudson will report a \$1,050,000 loss from discontinued operations in its Year 5 income statement:

Howard's Year 5 operating income	\$ 500,000
Impairment loss (\$8,000,000 NRV – \$10,000,000 book value)	<u>(2,000,000)</u>
Pretax loss from discontinued operations	(1,500,000)
Tax effect [30% × (\$1,500,000)]	<u>450,000*</u>
Income statement loss from discontinued operations	\$(1,050,000)

**The discontinued operations loss decreases Hudson's net income and, therefore, Hudson's taxes owed. Since discontinued operations caused Hudson's net income to decrease by \$1,500,000, the company will save \$450,000 (30% × \$1,500,000) in taxes.*

Foreign Currency Transactions



Representative Task (Application): Calculate transaction gains or losses recognized from monetary transactions denominated in a foreign currency.

Foreign currency transactions are transactions of a domestic entity denominated in (to be settled in) a foreign currency but to be recorded on the domestic entity's books in the domestic currency.



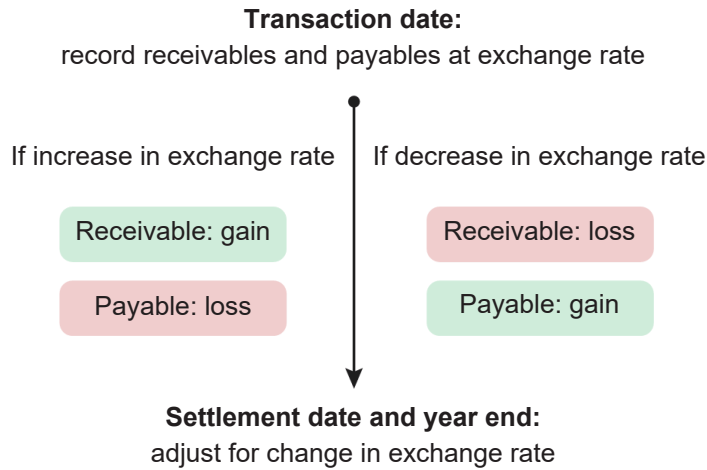
For example, a U.S. company buys goods from a Japanese company and agrees to pay for the goods with yen rather than dollars. In this case, the transaction is denominated in yen, but the amount recorded on the books of the U.S. entity is measured in U.S. dollars; therefore, the transaction amount must be converted from yen to dollars for reporting purposes.

When an entity enters into a transaction that will be settled in a foreign currency, a payable or receivable in a foreign currency is created. The payable or receivable is initially recorded in the entity's functional currency using the **transaction date exchange rate** (ie, spot rate).

These payables or receivables present a risk because of the changes in the exchange rates before settlement. As the exchange rate fluctuates between the time of purchase or sale and the time of payment, the company will record foreign currency transaction gains or losses (also called exchange gains or losses).

These gains or losses are recorded in net income. The company will also revalue the receivable or payable (ie, adjust its value on the balance sheet) to accurately present it at each reporting period.

Foreign Currency Gains and Losses



Over time, currencies can strengthen or weaken. A strengthening or weakening dollar means that the dollar buys more or less of the foreign currency. It also means that a company will receive more or less of the foreign currency owed to it. If the exchange rate changes from \$1 = €1.10 to \$1 = €1.15, or from £1 = \$0.95 to £1 = \$0.90, the dollar is *strengthening* in both scenarios.



For example, assume that a U.S. company has a €100,000 payable denominated in euros. If the dollar strengthens, fewer dollars will be required to purchase the same amount of euros. The payable is still €100,000; however, fewer dollars are now required to fulfill the obligation. The company will record a gain on the liability.

Strengthening or Weakening Currency and Transaction Gains and Losses

Domestic Currency Behavior	Impact	Transaction	
		Receivable Denominated in Foreign Currency	Payable Denominated in Foreign Currency
Domestic currency (dollar) weakens	More dollars are required to buy one unit of foreign currency	Transaction gain	Transaction loss
Domestic currency (dollar) strengthens	Fewer dollars are required to buy one unit of foreign currency	Transaction loss	Transaction gain

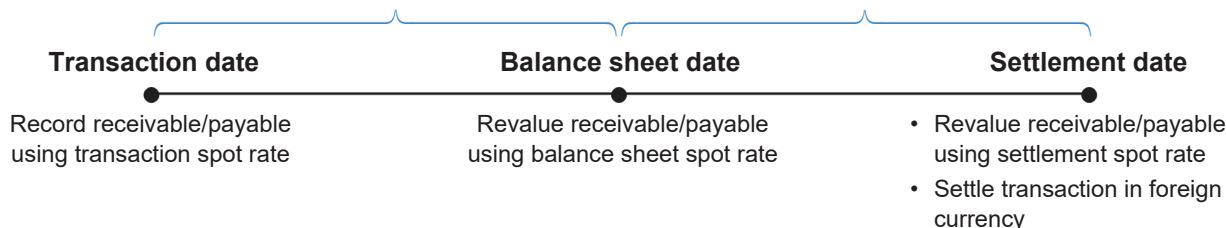
Foreign currency transactions are initially recorded at the transaction date. At the balance sheet date and settlement date, the associated receivables/payables are revalued, and a gain or loss is recorded through net income.

Foreign Currency Transactions



At **balance sheet date**, record foreign currency transaction gain/loss in income for difference in rate

At **settlement date**, record foreign currency transaction gain/loss in income for difference in rate



Stan Inc., a U.S. company, acquired machinery from a European manufacturer on October 1, Year 2 for €300,000. Payment was due in euros on January 31, Year 3. The spot rates to purchase one euro were as follows:

October 1, Year 2	\$2.00
December 31, Year 2	\$1.00
January 31, Year 3	\$1.45

Determine the initial journal entry that Stan will record and calculate the foreign currency transaction gain or loss that Stan will recognize in Year 2 and Year 3.

October 1, Year 2: Stan will record the machinery purchase in U.S. dollars, using the spot rate.

Purchase Machinery: €300,000 × \$2.00 (10/1 Year 2 Spot Rate)		
Machinery (historical exchange rate)	600,000	
Accounts payable		600,000

December 31, Year 2: The spot rate decreased from October 1 to December 31. A corresponding foreign currency transaction gain is recorded through net income in Year 2, reflecting the decreased dollars required to satisfy the payable.

Revalue Accounts Payable: (\$2.00 – \$1.00) × €300,000		
Accounts payable	300,000	
Foreign currency gain		300,000

The account payable is now valued on Stan's books at \$300,000 (\$600,000 – \$300,000).

January 31, Year 3: The spot rate increased from December 31 to January 31. A corresponding foreign currency transaction loss is recorded through net income in Year 3, reflecting the increased dollars required to satisfy the payable.

Revalue Accounts Payable: (\$1.00 – \$1.45) × €300,000		
Foreign currency loss	135,000	
Accounts payable		135,000

The account payable is now valued on Stan's books at \$435,000 (\$600,000 – \$300,000 + \$135,000).

Since the transaction was denominated in euros, Stan needs to purchase euros to settle the transaction on the date of settlement.

Purchase of Foreign Currency: €300,000 × \$1.45 (1/31 Year 3 Spot Rate)		
Investment in euros	435,000	
Cash		435,000

Stan will then settle the accounts payable by paying the euros to the European manufacturer.

Accounts payable	435,000	
Investment in euros		435,000

Foreign currency holdings (eg, euros) are still reported as cash on the balance sheet. Accordingly, those journal entries may be alternatively combined into a single entry:

Accounts payable	435,000	
Cash		435,000

Foreign currency transaction gains and losses are a **nonoperating item** and are recorded through net income. In a multi-step income statement, these gains and losses are part of nonoperating income (as shown in the multi-step income statement image above).



Foreign currency topics are tested in both the FAR and BAR exams. The FAR exam tests calculating transaction gains or losses recognized from monetary transactions denominated in a foreign currency (part of net income). The BAR exam tests calculating foreign currency translation adjustments (FAR candidates just need to remember these are a component of other comprehensive income, as described on the next page).

1.03 Statement of Comprehensive Income

Overview



Representative Task (Remembering & Understanding): Recall the purpose, objectives and structure of the statement of comprehensive income.



Representative Task (Remembering & Understanding): Identify items classified as other comprehensive income.

The purpose of reporting **comprehensive income** is to report a measure of overall enterprise performance. Comprehensive income includes all changes in equity during a period except those resulting from investments by owners/shareholders and distributions to owners/shareholders.

Net income is not replaced by comprehensive income. The purpose of requiring the reporting of comprehensive income is to report the net change in equity (other than from transactions with shareholders) in a single amount and to provide a more complete picture of the total earnings of the firm for a period.

The two components of comprehensive income are shown in the following equation:

$$\text{Comprehensive income} = \text{Net income} + \text{Other comprehensive income (OCI)}$$

Other Comprehensive Income (OCI)

OCI items are not recognized in net income. They are recorded directly as increases or decreases in shareholders' equity. The following items are included in OCI:

$$\text{Net income} + \text{Other comprehensive income} = \text{Comprehensive income}$$

- Derivative cash flow hedges
- Excess adjustment on defined benefit pension plans
- Net unrealized holding gains and losses on available-for-sale debt securities
- Translation adjustments from foreign currency

Accumulated other comprehensive income (AOCI) is a running total of OCI items through the balance sheet date. AOCI includes cumulative OCI for all periods (ie, current and prior periods). Just as net income is closed to retained earnings, OCI is closed to AOCI at the end of each reporting period.